Economic Outlook

5/11/87 B4750-2

Irving Trust

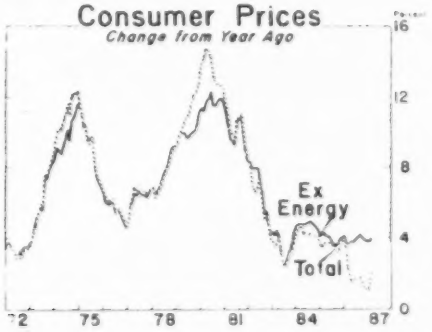
Irving Trust Company
One Wall Street
New York, NY 10015

Economic Research & Planning Division

April 1987

After more than two years of economic sluggishness, faster growth appears to have arrived. Signs of accelerated economic growth include respectable increases in employment and industrial production in the last two quarters, the recovery of business sales and new orders from January's slump, large gains in consumer income, the continued willingness of consumers to spend, and the narrowing of the trade deficit in real terms. The recent rise in the prime rate, which usually lags behind economic upturns, further confirmed that the economy has strengthened in recent months.

Faster economic growth this year will be accompanied by higher inflation. Although the annualized rate of increase in consumer prices of 6.7% in the first two months of this year overstates underlying inflationary pressure, an acceleration of inflation from last year's 1.1% is assured. As the following chart shows, the sharp decline in energy prices was solely responsible for last year's extremely low inflation rate. Excluding energy, the rate of inflation has remained remarkably stable at around 4% in the last three years. Simply the absence of further declines in oil prices this year would likely return the inflation rate to the 3.5%-4% range. However, oil prices have risen and are likely to stay at around $18 per barrel for the rest of this year. The rise in import prices resulting from the substantial depreciation of the dollar will also add to inflationary pressures. Prices for non-oil imports increased by more than 8% in 1986, and will rise further as the decline in the dollar continues. The rise in import prices also affords domestic producers more flexibility in raising their prices. As a result, price increases in the non-energy sector in 1987 will probably exceed the 4% rate that persisted in recent years. This, together with the rise in energy prices, will push the overall rate of inflation to close to 5% this year.



In the short-run, this moderate resurgence of inflation will be a stimulus to the economy. In the last two years, firms have kept inventories extremely lean. A resurgence of inflation this year will induce businesses to hold more inventories because they will profit from the price appreciation. We expect that inventory restocking will contribute 0.8% to real GNP growth this year,

(Continued)

in contrast to a negative contribution of 0.9% from reduced inventory investment in 1986. Consumer and business spending may also be stronger under higher inflation than they otherwise would be. The expectation of price increases provides an incentive for business and consumers to spend now rather than later.

Looking further ahead, 1987 may mark only the beginning of an upswing in inflation. The effect of the dollar depreciation so far has not yet been fully transmitted to domestic prices. Therefore, even in the unlikely event that the dollar were to stabilize at around current levels, inflation could still intensify in coming years. The failure of the Paris accord to stem the depreciation of the dollar suggests that short of a decisive reduction in the U.S. trade deficit, the dollar will have to fall further. The result will be even higher import prices and higher domestic inflation. Admittedly, this inflationary pressure could be curbed by a policy induced contraction of domestic demand. However, such a contraction risks a recession, and this risk may be too high a price to pay right now. The unabated LDC debt problem and an already strained world financial system limit policy makers' options. Between risk of inflation and risk of recession, inflation may seem the lesser evil to policy makers.

Victor Kung

Real GNP

(Percent Contribution to Real GNP Growth; Annual Rates)	Actual 1986				Forecast 1987				Actual		Forecast
	I	II	III	IV	I	II	III	IV	1984-1985	1985-1986	1986-1987
Consumer Spending	2.4	4.0	4.4	-0.2	-0.9	2.2	2.0	1.7	2.2	2.6	1.2
Business Investment	-2.1	-0.1	-0.3	0.4	-0.4	-0.1	0.1	0.3	1.1	-0.1	0.0
Residential Investment	0.5	0.6	0.5	0.3	0.3	0.3	-0.2	-0.2	0.2	0.5	0.2
Change in Inventories*	2.1	-2.9	-2.4	-0.4	3.0	-0.5	0.8	0.1	-1.0	-0.2	0.3
Net Exports	0.7	-3.0	-1.0	1.6	0.8	0.9	0.9	0.9	-0.7	-1.1	0.5
Government Purchases*	0.2	2.0	1.6	-0.6	0.3	0.6	0.5	0.5	0.9	0.8	0.5
Real GNP	3.8	0.6	2.8	1.1	3.1	3.4	4.1	3.3	2.7	2.5	2.7

Quarterly Economic Indicators

(Percent Changes at Annual Rates)	Actual 1986				Forecast 1987				Actual		Forecast
	I	II	III	IV	I	II	III	IV	1984-1985	1985-1986	1986-1987
Nominal GNP	6.2	2.6	6.4	1.7	7.4	7.4	8.4	7.6	6.2	5.2	6.0
GNP Deflator	2.5	1.8	3.6	0.7	4.2	3.8	4.1	4.2	3.3	2.7	3.2
Corporate Profits After Tax#	0.7	1.7	1.9	3.4	15.8	16.3	11.6	4.4	-6.3	1.9	11.8

Monthly Economic Indicators

	Recent Data			Actual		Forecast
	Dec.	Jan.	Feb.	1985	1986	1987
Consumer Price Index** (%)	0.2	0.7	0.4	3.8	1.1	4.8
Industrial Production (%)	0.5	0.1	0.5	2.2	1.0	3.3
Retail Sales (%)	4.9	-7.4	4.1	6.4	5.3	3.5
Auto Sales (million units, a.r.)	13.6	8.2	9.9	11.0	11.5	10.5
Housing Starts (million units, a.r.)	1.81	1.80	1.85	1.74	1.81	1.70
Unemployment Rate (%)	6.7	6.7	6.7	7.2	7.0	6.5
Merchandise Trade Deficit ($ bn., a.r.)	-152.4	-147.6	-181.2	-139.7	-166.3	-155.0

*Adjusted for CCC purchases. **Annual percent changes are December to December.
#Quarterly data are year-over-year percent changes.
a.r.=annual rate F=Forecast